

# Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended.

Local Government Type

☒ City ☐ Township ☐ Village ☐ Other

Local Government Name

City of Detroit Water Fund

County

Wayne

Audit Date  
6/30/04

Opinion Date  
1/14/05

Date Accountant Report Submitted to State:  
3/15/05

We have audited the financial statements of this local unit of government and rendered an opinion on financial statements prepared in accordance with the Statements of the Governmental Accounting Standards Board (GASB) and the *Uniform Reporting Format for Financial Statements for Counties and Local Units of Government in Michigan* by the Michigan Department of Treasury.

We affirm that:

1. We have complied with the *Bulletin for the Audits of Local Units of Government in Michigan* as revised.
2. We are certified public accountants registered to practice in Michigan.

As part of obtaining reasonable assurance about whether the Local unit's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not a objective of our audit, and accordingly, we do not express such an opinion. The results of our test disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. "Yes" responses have been disclosed in the financial statements, including the notes, or the report of comments and recommendations.

You must check the applicable box for each item below.

- ☐ Yes ☒ No 1. Certain component units/funds/agencies of the local unit are excluded from the financial statements.
- ☐ Yes ☒ No 2. There are accumulated deficits in one or more of this unit's unreserved fund balances/retained earnings (P.A. 275 of 1980).
- ☐ Yes ☒ No 3. There are instances of non-compliance with the Uniform Accounting and Budgeting Act (P.A. 2 of 1968, as amended).
- ☐ Yes ☒ No 4. The local unit has violated the conditions of either an order issued under the Municipal Finance Act or its requirements, or an order issued under the Emergency Municipal Loan Act.
- ☐ Yes ☒ No 5. The local unit holds deposits/investments which do not comply with statutory requirements. (P.A. 20 of 1943, as amended [MCL 129.91], or P.A. 55 of 1982, as amended [MCL 38.1132]).
- ☐ Yes ☒ No 6. The local unit has been delinquent in distributing tax revenues that were collected for another taxing unit.
- ☐ Yes ☒ No 7. The local unit has violated the Constitutional requirement (Article 9, Section 24) to fund current year earned pension benefits (normal costs) in the current year. If the plan is more than 100% funded and the overfunding credits are more than the normal cost requirement, no contributions are due (paid during the year).
- ☐ Yes ☒ No 8. The local unit uses credit cards and has not adopted an applicable policy as required by P.A. 266 of 1995 (MCL 129.241).
- ☐ Yes ☒ No 9. The local unit has not adopted an investment policy as required by P.A. 196 of 1997 (MCL 129.95).

## We have enclosed the following:

The letter of comments and recommendations.

Reports on individual federal financial assistance programs (program audits).

Single Audit Reports (ASLGU).

Enclosed	To Be Forwarded	Not Required
	✓	
	✓	✓

Certified Public Accountant (Firm Name)

KPMG LLP

Street Address

150 W. Jefferson Ave. Suite 1200

Accountant Signature

City

Detroit

State

MI

ZIP

48226

Date

3/15/05

# CITY OF DETROIT WATER FUND

## Table of Contents

	Page
Independent Auditors' Report	1
Balance Sheets	2
Statements of Revenues, Expenses, and Changes in Fund Net Assets	4
Statements of Cash Flows	5
Notes to Financial Statements	6



KPMG LLP  
Suite 1200  
150 West Jefferson  
Detroit, MI 48226-4429

## Independent Auditors' Report

The Board of Water Commissioners,  
the Honorable Mayor, and  
Members of the City Council  
City of Detroit, Michigan:

We have audited the accompanying balance sheets of the Water Fund (the Fund) of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the related statements of revenues, expenses, and changes in fund net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the changes in its financial position and its cash flows, where applicable, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Water Fund of the City of Detroit, Michigan as of June 30, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Fund has not presented Management's Discussion and Analysis, which accounting principles generally accepted in the United States of America have determined is necessary to supplement, although not required to be part of, the basic financial statements.

KPMG LLP

January 14, 2005

# CITY OF DETROIT WATER FUND

## Balance Sheets

June 30, 2004 and 2003

Assets	2004	2003
Current assets:		
Cash	\$ 3,811,324	7,394,716
Accounts receivable (including \$22,755,749 and \$22,876,659, respectively, for unbilled water services and net of allowance for doubtful accounts of \$30,237,264 and \$33,504,326 for June 30, 2004 and 2003, respectively)	64,702,852	54,902,171
Investments	13,491,812	10,106,541
Due from other funds	30,044,331	32,366,630
Inventories	6,832,006	7,454,375
Prepaid expenses	106,819	535,421
Restricted cash	21,717,159	40,699,474
Restricted investments	273,615,422	395,310,607
Restricted due from other funds	19,027,664	3,897,130
Total current assets	433,349,389	552,667,065
Other assets:		
Restricted long-term investments	22,769,343	30,454,410
Unamortized bond issuance costs	27,605,624	26,186,122
Capital assets:		
Land and land rights	6,527,438	6,358,342
Structures	453,406,152	431,915,880
Mains	689,057,547	672,467,862
Services, meters, and improvements to land	96,834,157	91,118,140
Equipment	492,782,490	432,868,661
Construction work in progress	679,745,387	608,364,217
Total capital assets	2,418,353,171	2,243,093,102
Less accumulated depreciation	(647,652,745)	(609,967,751)
Net capital assets	1,770,700,426	1,633,125,351
Total assets	\$ 2,254,424,782	2,242,432,948

See accompanying notes to financial statements.

Liabilities and Net Assets	2004	2003
Current liabilities:		
Current liabilities payable from current assets:		
Accounts and contracts payable	\$ 19,127,419	20,242,906
Accrued salaries and wages	1,817,697	1,590,668
Accrued workers' compensation	4,756,519	4,608,935
Accrued compensated absences	9,984,576	8,347,479
Due to other funds	49,168,308	65,762,817
Other current accrued liabilities	3,068,993	3,805,687
Total current liabilities payable from current assets	87,923,512	104,358,492
Current liabilities payable from restricted assets:		
Revenue bonds payable within one year	22,440,000	20,145,000
Accrued bond interest payable	32,246,376	34,050,879
Accounts and contracts payable	31,321,660	26,294,114
Other current accrued liabilities	621,531	626,068
Due to other funds	7,375,701	8,488,948
Total current liabilities payable from restricted assets	94,005,268	89,605,009
Long-term liabilities:		
Revenue bonds payable, less current portion (net of unamortized discount and gains on defeasance of \$59,570,404 and \$51,525,800, respectively)	1,631,424,596	1,647,314,200
Deferred swap termination fees	16,943,863	—
Accrued workers' compensation	11,021,735	9,169,640
Accrued compensated absences	5,604,945	5,578,370
Total long-term liabilities	1,664,995,139	1,662,062,210
Total liabilities	1,846,923,919	1,856,025,711
Net assets:		
Invested in capital assets, net of related debt	237,151,776	246,886,415
Restricted for capital acquisitions and bond payments	68,734,107	28,096,536
Unrestricted	101,614,980	111,424,286
Total net assets	407,500,863	386,407,237
Total liabilities and net assets	\$ 2,254,424,782	2,242,432,948

# CITY OF DETROIT WATER FUND

## Statements of Revenues, Expenses, and Changes in Fund Net Assets

Years ended June 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenues:		
Water sales – Detroit	\$ 70,881,142	65,455,321
Water sales – suburban	180,816,226	175,648,377
Miscellaneous	3,719,815	3,678,190
Total operating revenues	<u>255,417,183</u>	<u>244,781,888</u>
Operating expenses before depreciation:		
Source of supply	2,599,262	1,400,820
Low-lift pumping	5,628,218	5,402,838
Purification	17,406,399	15,967,195
High-lift pumping	18,614,963	26,208,834
Water quality operations	3,447,504	3,044,338
Transmission and distribution	52,903,044	44,469,194
Services and meters	3,398,813	10,773,132
Hydrant division	246,663	1,052,327
Commercial	6,244,587	5,578,007
Administrative and general	42,072,318	47,467,515
Total operating expenses before depreciation	<u>152,561,771</u>	<u>161,364,200</u>
Operating income before depreciation	102,855,412	83,417,688
Depreciation	<u>38,853,740</u>	<u>32,657,392</u>
Operating income	<u>64,001,672</u>	<u>50,760,296</u>
Nonoperating revenue (expense):		
Earnings on investments	4,223,627	6,453,901
Interest expense, net of capitalized interest	(52,210,199)	(55,307,703)
Miscellaneous	1,039,710	505,927
Total nonoperating expense	<u>(46,946,862)</u>	<u>(48,347,875)</u>
Contributed capital	<u>4,038,816</u>	<u>—</u>
Increase in net assets	<u>21,093,626</u>	<u>2,412,421</u>
Net assets – beginning of year	<u>386,407,237</u>	<u>383,994,816</u>
Net assets – end of year	<u>\$ 407,500,863</u>	<u>386,407,237</u>

See accompanying notes to financial statements.

# CITY OF DETROIT WATER FUND

## Statements of Cash Flows

Years ended June 30, 2004 and 2003

	2004	2003
Cash flows from operations:		
Receipts from customers	\$ 248,883,564	237,857,167
Transactions with other funds	(30,515,991)	(3,024,297)
Payments to suppliers	(109,534,716)	(99,225,068)
Payments to employees	(38,181,938)	(48,216,743)
Net cash provided by operating activities	<u>70,650,919</u>	<u>87,391,059</u>
Cash flows from capital and related financing activities:		
Contributions received from customers	4,038,816	—
Acquisition and construction of capital assets, net	(149,715,214)	(155,426,850)
Principal paid on revenue bond maturities	(19,740,000)	(19,400,000)
Interest paid on revenue bonds	(80,728,302)	(71,599,890)
Principal paid on refunded debt	(226,410,000)	(180,660,000)
Proceeds from bond issuance and increase in revolving note payable, net	226,410,000	584,609,444
Swap termination fee	16,943,863	—
Unamortized discount and bond issuance cost	4,725,892	3,801,720
Other receipts	1,039,710	505,927
Net cash provided by (used in) capital and related financing activities	<u>(223,435,235)</u>	<u>161,830,351</u>
Cash flows from investing activities:		
Sales and maturities of investments, net	125,994,982	(211,268,338)
Interest received on investments	4,223,627	6,453,901
Net cash provided by (used in) investing activities	<u>130,218,609</u>	<u>(204,814,437)</u>
Net increase (decrease) in cash	<u>(22,565,707)</u>	<u>44,406,973</u>
Cash at beginning of year	48,094,190	3,687,217
Cash at end of year	<u>\$ 25,528,483</u>	<u>48,094,190</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 64,001,672	50,760,296
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	38,853,740	32,657,392
Provision for uncollectible accounts	—	3,382,947
Changes in certain assets and liabilities:		
Increase in accounts receivable	(9,800,681)	(6,924,721)
Decrease in inventories	622,369	2,216,754
(Increase) decrease in prepaid expenses	428,602	(439,191)
Increase in accounts and contracts payable	3,912,059	16,970,619
Increase in accrued salaries and wages	227,029	111,708
Increase (decrease) in other accrued liabilities, compensated absences, and workers' compensation	2,922,120	(8,320,448)
Net change in due to (from) other funds	(30,515,991)	(3,024,297)
Net cash provided by operating activities	<u>\$ 70,650,919</u>	<u>87,391,059</u>

See accompanying notes to financial statements.

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

### (1) Summary of Significant Accounting Policies

The City of Detroit (the City) Charter established the Water Department (the Department) to supply water within and outside the City under the administration of the Board of Water Commissioners. The Water Fund (the Fund), an Enterprise fund, separately accounts for the Water Supply System (the System), as is required by bond ordinances of the City. The following is a summary of the more significant accounting policies followed in the preparation of the Fund's financial statements. These policies conform to accounting principles generally accepted in the United States of America.

#### (a) Basis of Accounting

The financial statements have been prepared on the economic resources measurement focus and the accrual basis of accounting. As allowed by Governmental Accounting Standards Board (GASB) Statement No. 20, the Fund follows all GASB pronouncements and Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins issued on or before November 30, 1989, except for those that conflict with a GASB pronouncement.

#### (b) Capital Assets

Capital assets are recorded at historical cost, together with interest capitalized during construction. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows:

Improvements to land	67 years
Structures	40 years
Mains	67 years
Services	67 years
Meters and equipment	3 – 20 years

#### (c) Inventories

Inventories are stated at the lower of average cost or market.



# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

**(d) Workers' Compensation**

The Fund has no insurance coverage for workers' compensation claims. Workers' compensation expenses are recorded when the occurrence of the liability is probable and the amount is reasonably estimable. The amounts recorded as of June 30, 2004 and 2003 are based on compensation expected to be paid, along with estimated medical costs, for all claims known as of the balance sheet date, and historical data are used in computing the liability for estimated incurred but unreported claims as of the balance sheet date. Changes in the liability since June 30, 2002 are summarized as follows:

		June 30		
		2004	2003	2002
Balance at beginning of year	\$	13,778,575	17,371,414	17,274,408
Current year claims and changes in estimates		6,756,198	1,016,096	3,981,944
Claims payments		(4,756,519)	(4,608,935)	(3,884,938)
Balance at end of year	\$	15,778,254	13,778,575	17,371,414

**(e) Capitalized Interest**

The Fund capitalizes qualifying net interest costs of the System on bonds issued for capital construction, in accordance with Statement of Financial Accounting Standards Nos. 34 and 62. Accordingly, capitalized interest for the years ended June 30, 2004 and 2003 was \$26,713,603 and \$20,279,731, respectively.

**(f) Taxes and City Services**

The Fund pays no direct federal, state, or local taxes, except local taxes on excess property and federal Social Security taxes. The Fund reimburses the City for most of the direct services furnished by other City departments, including general staff services. Charges are billed for all water services provided to City departments and the school district of the City.

**(g) Shared Costs**

Costs related to shared facilities and personnel are allocated to the Fund on a basis which relates costs incurred to the fund benefited.

**(h) Compensated Absences**

The Fund records as a liability estimated vested vacation, sick pay, and banked overtime in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. Unused vacation pay accumulates until termination of employment, while there is no vesting of sick pay until an employee reaches age 60 or completes 25 years of service.

**(i) Accrued Revenue**

The Fund records unbilled revenues for services provided prior to year-end by accruing actual revenues billed in the subsequent month.

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

*(j) Supplemental Disclosure of Cash Flow Information*

For purposes of reporting cash flows, the Fund considers "cash" as cash on deposit in financial institutions, including restricted assets.

*(k) Investments*

The Fund's investments are stated at fair value.

**(2) Definition of Operating Activities**

The Fund considers operating revenues and expenses to be those that result from activities related to the operations of the Water Supply System.

**(3) Cash and Investments**

Investment decisions are made in accordance with the City's official investment policy, which is in accordance with Michigan Public Act 20 of 1943 as amended; Michigan Public Act 94 of 1933 as amended; and bond ordinance provisions.

*(a) Cash*

At June 30, 2004 and 2003, the book value of the Fund's deposits was \$25,528,483 and \$48,094,190, respectively, with a corresponding bank balance of \$25,580,021 and \$46,631,783, respectively. Qualifying deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000. Of the bank balance at June 30, 2004 and 2003, \$241,614 and \$246,325 are insured, respectively. The remaining \$25,286,869 and \$46,385,458 is uninsured and uncollateralized, respectively.

*(b) Investments*

The Fund's investments are categorized below to give an indication of the level of risk assumed by the Fund as of June 30, 2004 and 2003. Category 1 includes investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. Investment pools are not categorized as to risk.

	Category	June 30	
		2004	2003
Government investment pools	N/A	\$ 133,261,673	165,137,177
Repurchase agreement	1	23,449,999	24,010,011
U.S. Treasury notes	1	30,475,737	30,468,462
Mortgage-backed securities	1	122,689,168	207,827,793
Commercial paper	1	—	8,428,115
		<u>\$ 309,876,577</u>	<u>435,871,558</u>

## CITY OF DETROIT WATER FUND

### Notes to Financial Statements

June 30, 2004 and 2003

#### (4) Restricted Assets

Restricted assets, principally cash and investments, are available for debt service on revenue bonds and to provide funds for improvements, enlargements, extensions, and construction. In certain instances, minimum levels of assets are required by bond ordinance provisions or by Board of Water Commissioners decree. These assets are maintained as follows: (1) With respect to the Bond and Interest Redemption Fund, after provision has been made for expenses of operation and maintenance of the System, a sum proportionately sufficient to provide for payment, when due, of the current principal and interest is set aside. The Bond Reserve account is part of the Bond and Interest Redemption Fund, and the amounts credited to this account are to be used only to pay principal and interest on the bonds when current revenues are not sufficient. (2) With respect to the Extraordinary Repair and Replacement Reserve Fund, after meeting the requirements of the foregoing funds, monthly deposits in an amount equal to one-twelfth of 3% of the budgeted operation and maintenance expense of the System for the fiscal year must be set aside until the aggregate amount funded totals at least 15% of that year's budgeted operating and maintenance costs. These deposits are to be used for major unanticipated repairs and replacement to the System with actual or anticipated cost exceeding \$1 million. Once this fund is fully funded, deposits required are amounts needed to maintain fully funded status. Borrowings of up to 50% of the balance in this fund on the first day of the related fiscal year are allowed for transfer to and use from the Improvement and Extension Fund. Any such borrowings must be repaid prior to any deposits being made to the Improvement and Extension Fund. (3) After the above deposits have been made, excess amounts may be deposited in the Improvement and Extension Fund, established for the payment of improvements, enlargements, repairs, extensions, or betterment to the System. (4) With respect to the Construction Fund, the portion of the proceeds of the sale of bonds for building or improving the System is deposited in this fund. A separate depository account is required for each series of bonds. Proceeds for construction purposes received from federal and state grants and other sources which restrict the use of such proceeds are also deposited into this account.

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

### (5) Capital Assets

Capital asset activity for the fiscal years ended June 30, 2004 and 2003 are as follows:

	Balance, June 30, 2003	Additions	Disposals	Balance, June 30, 2004
Nondepreciated capital assets:				
Land and land rights	\$ 6,358,342	169,096	—	6,527,438
Construction in progress	608,364,217	157,981,415	(86,600,245)	679,745,387
	<u>614,722,559</u>	<u>158,150,511</u>	<u>(86,600,245)</u>	<u>686,272,825</u>
Depreciated capital assets:				
Services, meters, and improvements to land	91,118,140	5,993,232	(277,215)	96,834,157
Structures	431,915,880	178,585,147	(157,094,875)	453,406,152
Mains	672,467,862	96,046,142	(79,456,457)	689,057,547
Equipment	432,868,661	159,833,248	(99,919,419)	492,782,490
Accumulated depreciation	(609,967,751)	(38,853,740)	1,168,746	(647,652,745)
	<u>1,018,402,792</u>	<u>401,604,029</u>	<u>(335,579,220)</u>	<u>1,084,427,601</u>
Total	<u>\$ 1,633,125,351</u>	<u>559,754,540</u>	<u>(422,179,465)</u>	<u>1,770,700,426</u>
	Balance, June 30, 2002	Additions	Disposals	Balance, June 30, 2003
Nondepreciated capital assets:				
Land and land rights	\$ 5,146,947	1,211,395	—	6,358,342
Construction in progress	549,851,782	211,793,778	(153,281,343)	608,364,217
	<u>554,998,729</u>	<u>213,005,173</u>	<u>(153,281,343)</u>	<u>614,722,559</u>
Depreciated capital assets:				
Services, meters, and improvements to land	87,312,719	3,941,336	(135,915)	91,118,140
Structures	407,884,323	177,783,068	(153,751,511)	431,915,880
Mains	648,999,324	80,326,630	(56,858,092)	672,467,862
Equipment	370,274,409	181,262,445	(118,668,193)	432,868,661
Accumulated depreciation	(579,392,483)	(32,657,392)	2,082,124	(609,967,751)
	<u>935,078,292</u>	<u>410,656,087</u>	<u>(327,331,587)</u>	<u>1,018,402,792</u>
Total	<u>\$ 1,490,077,021</u>	<u>623,661,260</u>	<u>(480,612,930)</u>	<u>1,633,125,351</u>

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

### (6) Indebtedness

The outstanding indebtedness of the Fund for revenue bonds was \$1,713,435,000 and \$1,718,985,000 at June 30, 2004 and 2003, respectively. The interest rates on the outstanding fixed-rate revenue bonds range from 4.30% to 6.38%. Net revenues of the Fund are pledged to repayment of bonds.

Future debt service requirements as of June 30, 2004 are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total requirements</u>
Year ending June 30:			
2005	\$ 22,440,000	74,620,070	97,060,070
2006	23,305,000	80,896,124	104,201,124
2007	25,470,000	80,118,902	105,588,902
2008	27,905,000	79,220,511	107,125,511
2009	29,235,000	77,871,634	107,106,634
2010 - 2014	171,020,000	365,351,477	536,371,477
2015 - 2019	221,985,000	316,283,526	538,268,526
2020 - 2024	280,810,000	258,945,960	539,755,960
2025 - 2029	355,040,000	187,564,319	542,604,319
2030 - 2034	452,085,000	80,390,452	532,475,452
2035 - 2039	104,140,000	1,559,250	105,699,250
	<u>\$ 1,713,435,000</u>	<u>1,602,822,225</u>	<u>3,316,257,225</u>

In fiscal 2004, the Fund issued \$240,600,000 of City of Detroit, Michigan Water Supply System Revenue Senior Lien Bonds consisting of; \$77,010,000 of City of Detroit, Michigan Water Supply System Revenue Refunding Second Lien Bonds (Variable Rate Demand) Series 2004-A; and \$163,590,000 of City of Detroit, Michigan Water Supply System Revenue Refunding Senior Lien Bonds (Variable Rate Demand) Series 2004-B. The net proceeds were used to refund a portion of the City's outstanding Water Supply System Revenue Bonds and Revenue Refunding Bonds and to pay cost of issuance associated with the 2004 Bonds.

The proceeds of the Revenue Refunding Second Lien Bonds, Series 2004-A were used to advance-refund \$70,830,000 of outstanding Water Supply System Revenue Second Lien Bonds, Series 1995-A, maturing in the years 2015 and 2025 with an average interest rate of 5.5%. The net proceeds of \$76,165,192 (after payment of \$844,808 in underwriting fees, insurance, and other issuance costs) were used to purchase U.S. Government securities.

The proceeds of the Revenue Refunding Senior Lien Bonds, Series 2004-B were used to advance-refund \$12,610,000 of outstanding Water Supply System Revenue and Refunding Bonds, Series 1993, maturing serially in the years 2005 through 2009; \$30,000,000 of Series 1993 Term Bonds, maturing in the year 2013; \$58,030,000 of Series 1993 Term Bonds, maturing in the year 2019; and \$54,940,000 of Series 1993 Term Bonds, maturing in the year 2023. The net proceeds of \$161,794,783 (after payment of \$1,795,217 in underwriting fees, insurance, and other issuance costs) were used to purchase U.S. Government securities.

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

Those refunded securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 1993 Series Bonds and provided for partial future debt service payments on the 2001-A Series Bonds. As a result, the 1993 Series Bonds and a portion of the 2001-A Series Bonds are considered to be defeased, and the liability for those bonds has been removed from the balance sheet.

The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$18,639,245. This difference, reported in the financial statements as a deduction from bonds payable, is being charged to operations through the year 2025 using the straight-line method. The Fund completed the advance refunding to reduce its total debt service payments over the next 21 years and to obtain an economic gain (difference between the present values of the old and new debt service payments) of \$12,105,118.

In prior years, the Fund defeased certain bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Fund's financial statements. Similarly, the interest expenses related to the defeased bonds and the related interest income earned on the escrow fund investments have not been recognized in the statements of revenues, expenses, and changes in fund net assets. As of June 30, 2004 and 2003, approximately \$546,360,000 and \$370,800,000, respectively, of bonds outstanding are considered defeased.

Bonds outstanding at June 30, 2004 include \$1,390,050,000 of bonds callable at various dates after June 30, 2004. These bonds are callable at varying premiums, depending on the issue and length of time to maturity.

### (7) Long-term Liabilities

Long-term activity for the years ended June 30, 2004 and 2003 is as follows:

	Balance, June 30, 2003	Increase	Decrease	Balance, June 30, 2004	Amount due within one year
Bonds payable, net	\$ 1,667,459,200	240,600,000	(254,194,604)	1,653,864,596	22,440,000
Accrued workers' compensation	13,778,575	6,756,198	(4,756,519)	15,778,254	4,756,519
Accrued compensated absences	13,925,849	1,810,212	(146,540)	15,589,521	9,984,576
Total	<u>\$ 1,695,163,624</u>	<u>249,166,410</u>	<u>(259,097,663)</u>	<u>1,685,232,371</u>	<u>37,181,095</u>

	Balance, June 30, 2002	Increase	Decrease	Balance, June 30, 2003	Amount due within one year
Bonds payable, net	\$ 1,270,767,691	593,759,746	(197,068,237)	1,667,459,200	20,145,000
Accrued workers' compensation	17,371,414	1,016,096	(4,608,935)	13,778,575	4,608,935
Accrued compensated absences	13,243,946	2,121,445	(1,439,542)	13,925,849	8,347,479
Total	<u>\$ 1,301,383,051</u>	<u>596,897,287</u>	<u>(203,116,714)</u>	<u>1,695,163,624</u>	<u>33,101,414</u>

# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

### (8) Derivatives Not Reported at Fair Value

The Fund is a party to derivative financial instruments consisting of interest rate swaps that are intended to effectively convert variable-rate debt to fixed-rate debt. These are not reported at fair value on the statement of net assets at June 30, 2004.

**Objective of the swaps:** In order to better manage its interest rate exposure and to reduce the overall costs of its borrowing, the Fund has entered into 17 separate fixed-payor interest rate swaps.

**Terms, fair values, and credit risk:** Certain key terms, fair market values, and counterparty credit ratings relating to the outstanding swaps as of June 30, 2004 are presented below. The notional amounts of the swaps, except those with effective dates of April 1, 2005 and March 1, 2007, match the principal amounts of the outstanding debt. The swaps with effective dates of April 1, 2005 and March 1, 2007 were entered into to hedge future interest rate risk and will be associated with bonds expected to be issued prior to the effective dates. Except as discussed under rollover risk, the Fund's swap agreements contain scheduled reductions to outstanding notional amounts that match scheduled or anticipated amortization of associated bonds.

Associated bond issue	Notional amounts (1)	Effective date	Fixed rate paid	Variable rate received	Fair value	Swap termination date	Final maturity of bonds	Counterparty credit rating
Water 2001-C (3)	\$ 47,723,000	6/6/97	4.070%	BMA (2)	\$ (1,813,209)	12/31/2001	6/30/2025	Aaa/AA+/NR
Water 2001-C (3)	30,032,000	6/6/97	4.695%	BMA	(2,456,809)	6/30/2007	6/30/2025	Aaa/AA+/NR
Water 2001-C (3)	47,628,000	12/31/01	5.415%	BMA	(3,142,701)	6/30/2007	6/30/2025	Aaa/AA+/NR
Water 2001-C	114,150,000	6/6/97	4.900%	BMA	(14,671,784)	6/30/2022	6/30/2022	Aaa/AA+/NR
Water 2003-B	1,980,000	1/29/99	3.020%	CPI + 1.01%	35,471	6/30/2005	6/30/2005	Aa3/A+/AA-
Water 2003-B	2,290,000	1/29/99	3.310%	CPI + 1.12%	34,077	6/30/2006	6/30/2006	Aa3/A+/AA-
Water 2003-B	2,500,000	1/29/99	3.550%	CPI + 1.25%	35,834	6/30/2007	6/30/2007	Aa3/A+/AA-
Water 2003-B	2,175,000	1/29/99	3.740%	CPI + 1.33%	27,647	6/30/2008	6/30/2008	Aa3/A+/AA-
Water 2003-B	2,800,000	1/29/99	3.870%	CPI + 1.34%	25,667	6/30/2009	6/30/2009	Aa3/A+/AA-
Water 2003-B	2,505,000	1/29/99	4.000%	CPI + 1.36%	11,590	6/30/2010	6/30/2010	Aa3/A+/AA-
Water 2003-C	2,005,000	1/29/99	3.870%	CPI + 1.34%	18,214	6/30/2009	6/30/2009	Aa3/A+/AA-
Water 2003-C	2,330,000	1/29/99	4.000%	CPI + 1.36%	10,747	6/30/2010	6/30/2010	Aa3/A+/AA-
Water 2003-D	151,370,000	2/5/99	4.060%	BMA	(5,616,502)	6/30/2029	6/30/2029	Aa2/AA-/NR
Water 2004-A	77,010,000	5/12/00	3.940%	BMA	(2,156,755)	6/30/2021	6/30/2021	Aa2/AA-/NR
Water 2004-B	163,590,000	5/12/00	3.845%	BMA	(3,771,652)	6/30/2019	6/30/2019	Aa2/AA-/NR
Water Forward Starting Swap	195,000,000	3/31/01	4.710%	BMA	(3,044,079)	6/30/2032	N/A	Aa3/A+/AA-
Water Forward Starting Swap	120,000,000	2/28/03	5.000%	BMA	(1,684,838)	6/30/2032	N/A	Aa3/A+/AA-

1. Notional amount balance as of July 1, 2004

2. The Bond Market Association Municipal Swap Index

3. Denotes that the swap termination date does not match the final maturity of the bonds

**Fair value.** Because interest rates have generally declined since the time the swaps were negotiated, most of the Fund's swaps have a negative fair value as of June 30, 2004. The negative fair values may be countered by lower total interest payments required under the variable-rate bonds, creating lower synthetic interest rates.

**Credit risk.** As of June 30, 2004, the Fund was not exposed to net credit risk, because the swaps had net negative fair values. However, should interest rates change and fair values of the swaps become positive, the Fund would be exposed to credit risk in the amount of the derivatives' positive fair value.

## CITY OF DETROIT WATER FUND

### Notes to Financial Statements

June 30, 2004 and 2003

The swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below certain rating levels by Fitch Ratings, Standard & Poor's, and/or Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. Government securities held by a third-party custodian.

**Basis risk.** The Fund is not exposed to significant basis risk on its swaps, because most of the variable payments received are based on the BMA index. The CPI indexed swaps are associated with CPI indexed bonds and thus create no basis risk.

**Termination risk.** The Fund or counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In such cases, the Fund may owe or be due a termination payment, depending on the value of the swap at that time. In addition, the Fund is exposed to termination risk, but not termination payments, on certain of the Fund's swaps related to Water Series 2001-C, Water Series 2003-D, Water Series 2004-A, and Water Series 2004-B. These swaps provide the counterparty with the option to terminate the swap agreement beginning on January 1, 2010, July 2, 2011, July 1, 2005, and July 1, 2005, respectively, upon the passing of certain BMA thresholds. If any of these swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates, but there would be no termination payment.

**Rollover risk.** The Fund is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated debt. When these swaps terminate, or, in the case of the termination option, if the counterparty exercises its option, the Fund will not realize the synthetic rate offered by the swaps on the underlying debt issues.

#### (9) Deferred Swap Termination Proceeds

During the year ended June 30, 2004, the Fund and its counterparty terminated a forward starting swap agreement related to the future issuance of debt in fiscal year 2005. The Fund received a termination payment in the amount of \$16,943,863 that has been deferred to offset future debt service. The proceeds will be recognized over the life of the debt that will be issued in fiscal year 2005 using the straight-line method.

#### (10) Pension Costs and Obligation for Benefits

The City provides retirement benefits to its employees through the General Retirement System (the Retirement System). The Retirement System provides benefits through a single-employer, defined contribution plan covering substantially all Fund employees and a defined benefit plan. Historical and trend information for the defined benefit retirement plan is located in the City's comprehensive annual financial report. The City's funding policy provides for periodic employer contributions at actuarially determined rates that are designed to accumulate sufficient assets to pay benefits when due. The Water Fund incurred pension expenses of \$16,814,426 and \$12,371,235 in fiscal years 2004 and 2003, respectively. Consulting actuaries determined the City's contributions to the Retirement System as a percentage of annual covered payroll for normal costs. The Retirement System's actuarially determined pension benefit obligation information is not separately available for the Fund.



# CITY OF DETROIT WATER FUND

## Notes to Financial Statements

June 30, 2004 and 2003

Significant actuarial assumptions used for the year ended June 30, 2004 are as follows:

Valuation date	June 30, 2003	June 30, 2002
Actuarial cost method	Entry Age	Entry Age
Amortization method	Level Percent	Level Percent
Remaining amortization period	15 years	19 years
Asset valuation method	3-year Smoothed Market	3-year Smoothed Market
Actuarial assumptions:		
Investment rate of return	7.9%	7.9%
Projected salary increases	4.0% – 9.5%	4.0% – 10.0%
Includes inflation at:	4.0%	4.0%
Cost-of-living adjustment	2.25%	2.25%

Additional information regarding citywide employee participation, benefit obligations, and funding status for the Retirement System is available in the City's comprehensive annual financial report.

### (11) Due to (from) Other Funds

During the course of operations, numerous transactions occur between individual funds and other City of Detroit funds for goods provided or services rendered. Related receivables and payables are classified as "due from other funds" or "due to other funds" on the balance sheets and are summarized as follows:

	2004	2003
Due from other funds (unrestricted):		
General Fund	\$ 837,888	706,755
Sewage Disposal Fund	29,206,443	31,659,875
Total due from other funds	<u>\$ 30,044,331</u>	<u>32,366,630</u>
Due from other funds (restricted):		
General Fund	\$ 15,909,184	324,852
Sewage Disposal Fund	3,118,480	3,572,278
Total due from other funds	<u>\$ 19,027,664</u>	<u>3,897,130</u>
Due to other funds (unrestricted):		
General Fund	\$ 10,748,254	11,018,883
Sewage Disposal Fund	38,420,054	54,743,934
Total due to other funds	<u>\$ 49,168,308</u>	<u>65,762,817</u>
Due to other funds (restricted):		
General Fund	\$ 290,175	290,175
Sewage Disposal Fund	7,085,526	8,198,773
Total due to other funds	<u>\$ 7,375,701</u>	<u>8,488,948</u>

## **CITY OF DETROIT WATER FUND**

### **Notes to Financial Statements**

**June 30, 2004 and 2003**

#### **(12) Capital Improvement Programs**

The Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this Program is anticipated to be approximately \$1.6 billion through fiscal year 2009. The Program is being primarily financed from revenues of the Fund and proceeds from the issuance of revenue bonds.

The total amount of construction contract commitments outstanding at June 30, 2004 and June 30, 2003 was approximately \$238 million and \$343 million, respectively.

#### **(13) Contingencies**

The Fund is a defendant in numerous alleged claims, lawsuits, billing disputes, and other stated and pending demands. The Fund and the City's Legal Department have estimated a reserve, which is included in the accompanying financial statements, for the potential outcome of such claims or the amount of potential damages in the event of an unfavorable outcome for each of the above contingencies. The Fund's management and the City's Legal Department believe that any differences in reserved amounts and final settlement, after consideration of claims covered by insurance, resulting from such litigation will not materially impact the Fund's financial position or results of operations.